MOTION FILED

FEB 3 1976

IN THE

Supreme Court of the United States

OCTOBER TERM, 1975

No. 75-1065

JOHN NUVEEN & CO., INC., *et al.*,

Petitioners,

—v.—

HENRY T. SANDERS,

Respondent.

MOTION OF SECURITIES INDUSTRY ASSOCIATION FOR LEAVE TO FILE BRIEF AND BRIEF AS *AMICUS CURIAE* IN SUPPORT OF THE PETITION FOR A WRIT OF CERTIORARI

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MOTION OF SECURITIES INDUSTRY ASSOCIATION FOR LEAVE TO FILE BRIEF AS *AMICUS CURIAE* IN SUPPORT OF THE PETITION FOR A WRIT OF CERTIORARI

The Securities Industry Association ("SIA" or "Association") respectfully moves, pursuant to Rule 42 of the Rules of this Court, for leave to file a brief *amicus curiae* in support of the petition for a writ of certiorari of John Nuveen & Co., Inc., Investors Syndicate of America, Inc. and Investors Diversified Services, Inc. ("Petitioners"). Petitioners have consented to filing of an *amicus* brief by SIA; respondent has refused such consent.

SIA is a trade association with some 650 members engaged in the securities business; its members are located throughout the United States. SIA was formed in 1972 through merger of the Association of Stock Exchange Firms and the Investment Bankers Association of America. Among the members of SIA are all the principal commercial paper dealers in the United States. Petitioner

John Nuveen & Co., Inc. ("Nuveen"), a member, presently is engaged principally in the purchase and sale of municipal securities and securities of the United States Government and agencies thereof, and sale of securities of municipal bond funds; the Association's broker/dealer membership typically includes firms more broadly engaged in the securities industry than is Nuveen. SIA is widely recognized as a securities industry spokesman to the public and to Government.

Applicant and its members have a substantial interest in the granting of the petition because:

(1) The decision below has the effect of making dealers in short-term notes virtual guarantors of payment of such notes. The volume of such dealer paper outstanding at the end of September, 1975, exceeded seventeen billion dollars, and SIA members handled an estimated 90% of that dealer business.

(2) The decision below enlarges statutory obligations and liability of underwriters of and dealers in all securities, by undermining the right of persons engaged in the distribution of securities to rely upon the authority of experts, despite specific provisions in the Securities Act of 1933 authorizing such reliance, and does so in circumstances where no reason was found to exist before sale of the notes to question the financial statements certified by independent public accountants.

(3) The decision below effectively holds securities underwriters and dealers who operate in a national market to standards materially different from those enunciated by

other courts of appeals, thereby leaving great uncertainty as to obligations of SIA's members, and making liability for their conduct under federal securities law dependent upon the fortuity of where they may be sued.

By the accompanying brief, SIA seeks to bring to the Court's attention the pervasive ramifications of the decision below upon distribution of securities through underwriters and dealers and to emphasize certain legal issues of critical importance to the securities industry. It is urged that the Court grant SIA's motion for leave to file the attached brief in support of the petition for a writ of certiorari herein.

February 2, 1976

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BRIEF OF SECURITIES INDUSTRY ASSOCIATION, *AMICUS CURIAE*, IN SUPPORT OF THE PETITION FOR A WRIT OF CERTIORARI

On behalf of members of the securities industry engaged in virtually all facets of the capital formation process, the Securities Industry Association ("SIA") urges as *amicus curiae* that the Petition for a Writ of Certiorari should be granted. The decision of the Court of Appeals for the Seventh Circuit improperly imposes—under §10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b), the sole basis for liability below—obligations and risks of liability upon underwriters, and upon dealers in commercial paper (and, inferentially, other securities), which are unwarranted under §10(b) of the Securities Exchange Act and contrary to provisions of §11 of the Securities Act of 1933, 15 U.S.C. §77k.

Opinion Below

There are two opinions by the Court of Appeals: *Sanders* v. *John Nuveen & Co., Inc.,* 463 F.2d 1075 (7th Cir.), *cert. denied,* 409 U.S. 1009 (1972), hereinafter called *"Sanders I"*; and *Sanders* v. *John Nuveen & Co., Inc.,* 524 F.2d 1064 (7th Cir. 1975), hereinafter called *"Sanders II"*. The opinions respectively are at page 49, *et seq.*, and page 1, *et seq.*, of the Appendix to Petition for a Writ of Certiorari filed by John Nuveen & Co., Inc., Investors Syndicate of America, Inc. and Investors Diversified Services, Inc. ("Petitioners").

On certification pursuant to 28 U.S.C. §1292(b), the Court of Appeals held in *Sanders I,* 463 F.2d at 1077-81, *inter alia,* that purchasers from John Nuveen & Co., Inc. ("Nuveen") of ninety-day promissory notes that were not paid when due by the issuer, Winter & Hirsch, Inc. ("WH"), could maintain a damage action against Nuveen under §10(b) of the 1934 Act, despite the 1934 Act exemption from the definition of a "security" for "any note . . . which has a maturity at the time of issuance of not exceeding nine months," 15 U.S.C. §78c(a)(10).

Subsequent proceedings in the District Court resulted in the determination that Nuveen, and related defendants who allegedly controlled Nuveen, were liable for the face amount of the defaulted notes Nuveen had sold, plus interest thereon. On review by the Circuit Court in *Sanders II,* it was held that, ". . . Nuveen's liability in this case must rest on Rule 10b-5." 524 F.2d at 1069 (footnote omitted).

Questions Presented and Statutes Involved

The statement of Petitioners of the questions presented herein includes the three issues that SIA, as *amicus curiae,* urges are of importance: (1) whether short-term promissory notes are excluded from the ambit of the 1934 Act; (2) whether participants in the distribution of securities (other than the issuer) may rely upon reports of experts; and (3) what standards of conduct should be utilized to measure liability under §10(b) of the 1934 Act. In the interest of brevity, Petitioners' statement of those questions (Petition, pp. 2-3) is adopted. However, because of the interest of SIA and its members in potentially broader ramifications of the answers to certain of these questions, its discussion of those issues (Argument, Points II and III, *infra*) is in the context of securities generally, and is not restricted to short-term notes.

Relevant sections of the Securities Act of 1933 and Securities Exchange Act of 1934 are specified by Petitioners (Petition, p. 3) and included in the Appendix (p. 69, *et seq.*) to their Petition.

Statement of the Case

We adopt the recitation of relevant facts as set forth by Petitioners in their Statement of the Case (Petition, pp. 3-8). We wish to emphasize, however, that the court below specifically found that: The issuer of the short-term notes here involved, WH, was "an old established firm with a fine reputation"; and, in dealing in WH paper, Nuveen "acted in the mistaken but honest belief that financial statements prepared by [WH's] certified public accountants correctly represented the condition of the issuer." *Sanders II,* 524 F.2d at 1071, 1066.

ARGUMENT

I

This Court should determine whether short-term notes are securities within the ambit of the 1934 Act.

As noted, the sole basis for the Circuit Court's conclusion that Nuveen is liable is §10(b) of the 1934 Act and Rule 10b-5 thereunder. Section 10(b) in terms applies to transactions "in connection with the purchase or sale of any security", 15 U.S.C. §78j(b). However, §3(a)(10) of the 1934 Act specifically defines "security" so as to exclude, without qualification, notes with "a maturity at the time of issuance of not exceeding nine months", 15 U.S.C. §78c (a)(10).* Since short-term notes (which constitute "commercial paper") are unequivocally removed from the coverage of the 1934 Act, a serious issue obviously arises as to whether that statute may be construed, contrary to its express terms, to apply to the sale of commercial paper.

In reaching a conclusion purportedly based upon, but in fact specifically contrary to, the provisions of the 1934 Act, the court below sought support for its conclusion in a policy of interpreting broadly the federal securities laws in aid of remedial objectives. To this end it relied heavily upon

* It is significant, in this connection, to compare the language of §3(a)(10) of the 1934 Act (defining the scope of the statute's coverage) with the language of §3(a)(3) of the 1933 Act affording only an exemption from the requirements of the registration provisions of that Act. In the 1933 Act, only short-term notes issued in connection with a "current transaction" are exempted and then only from the registration requirements of the Act.

an SEC interpretation of the 1933 Act* setting forth the characteristics required of short-term notes in order that they qualify for the exemption from registration provided by §3(a)(3) of that Act. *Sanders I*, 463 F.2d at 1077-79.

The opinion in *Sanders I* acknowledged that, unlike other securities acts where Congress "expressly" included short-term notes within the coverage provided by their statutory protections, the 1934 Act did not; but the court below nonetheless concluded that, "Congress intended to protect against fraud the purchasers of securities such as those involved here under the 1934 act as well." 463 F.2d at 1079-80 (footnote omitted).**

That reasoning is contrary to this Court's most recent interpretation of these securities statutes, where this Court emphasized that, "[T]he congressional purpose does not require resolving every ambiguity in favor of liability . . .", *Foremost-McKesson, Inc.* v. *Provident Securities Co.*, 44 U.S.L.W. 4056, 4062 (U.S. Jan. 13, 1976) (interpreting §16(b) of 1934 Act). In that decision, this Court specifically rejected the suggestion that the language and purpose of an express limitation upon the reach of a statutory provision may be disregarded in the name of service to the general remedial purpose of the 1934 Act, even where the provision under consideration is ambiguous:

* Release No. 33-4412, 17 C.F.R. 231.4412 (1961). The language of § 3(a)(3), *i.e.*, "which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions", may leave room for interpretative rule-making; the language of § 3(a)(10) of the 1934 Act is precise, clear and unambiguous.

** Petitioners herein were not found to have committed "fraud". The district court held Nuveen liable "on the theory that it breached a duty to make reasonable inquiries . . . ." *Sanders II*, 524 F.2d at 1066.

> "We find this approach unsatisfactory in its focus on situations that §16(b) may not reach rather than on the *language and purpose of the exemptive provision itself.*" *Id.* at 4060 (emphasis added).

Here, where the congressional language is unambiguous, "the texts of the 1933 and 1934 Acts as to the congressional scheme" appear to mandate the conclusion that purchasers of short-term commercial paper cannot base claims upon the 1934 Act, particularly since Congress "had little trouble in doing so expressly" in the 1933 Act when it "wished to provide a remedy" available to purchasers of short-term notes.* *Cf. Blue Chip Stamps* v. *Manor Drug Stores,* 421 U.S. 723, 733-34 (1975).

Maintenance of the distinction between 1933 Act and 1934 Act applicability to commercial paper is of major public consequence. The quantum of commercial paper is huge, and its role in the financing of American enterprise can hardly be exaggerated. For example, at the end of each of the years 1973 and 1974 and at September 30, 1975, there was outstanding more than 40 billion dollars of commercial paper, and over 17 billion dollars of that paper in September, 1975, represented capital raised by commercial paper dealers (61 Fed. Reserve Bull. A-25, Dec. 1975). If dealers in commercial paper are to be held to the liabilities of the 1934 Act, and deprived of 1933 Act statutory defenses (Point II, *infra*), it may be anticipated that major changes

* *See* §12(2) of the '33 Act, which applies to "a security (whether or not exempted by the provisions of section 3 . . .)", 15 U.S.C. §77*l*(2); and §17(c) of the '33 Act, which provides that, "The exemptions provided in section 3 shall not apply to the provisions of this section", 15 U.S.C. §77q(c).

in commercial paper marketing will be required, including substantially increased costs to compensate dealers for their increased risks. We discuss in Point III, *infra,* the uncertainties of these risks under §10(b) as it has been variously construed in the several circuits.

But whatever the touchstone of liability,* this Court should resolve the question as to whether the 1934 Act applies to this type of financing.

II

The decision below undermines the right of persons engaged in the distribution of securities to rely upon the authority of experts, and effectively makes underwriters guarantors of the accuracy of financial statements certified by independent public accounts.

The "principal question" addressed in *Sanders II* was:

> ". . . whether an underwriter of short term commercial paper, who acted in the mistaken but honest belief that financial statements prepared by certified public accountants correctly represented the condition of the issuer is liable to its customers for losses sustained as a result of the issuer's default." 524 F.2d at 1066.

Assuming *arguendo* that Nuveen was an "underwriter", it becomes pertinent to examine the significance of that appellation in the statutory scheme. The term "under-

* We again note the anomaly that Nuveen, whom the court characterized as acting in a "mistaken but honest belief that . . . [certified financial statements] correctly represented the condition of the issuer", should be held liable under what this Court recently has characterized as "general antifraud" provisions of an Act which expressly excludes short-term notes from its parameters. *See Foremost-McKesson, Inc.* v. *Provident Securities Co., supra,* 44 U.S.L.W. at 4063.

writer" comes from the 1933 Act, 15 U.S.C. §77b(11). As used in the 1933 Act scheme, strict liability is imposed under §11 upon certain classes of persons, including issuers and underwriters, if a registration statement filed in connection with a securities offering is materially false or misleading, subject, however, to specified defenses available to underwriters but not to issuers. 15 U.S.C. §77k.

Section 11(b)(3)(C) provides that, "[N]o person, other than the issuer, shall be liable as provided therein who shall sustain the burden of proof—

• • • • •

"(3) that . . .

"(C) as regards any part of the registration statement purporting to be made on the authority of an expert (other than himself) . . . he had no reasonable ground to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or that such part of the registration statement did not fairly represent the statement of the expert or was not a fair copy of or extract from the report or valuation of the expert; . . . ."

There can be no doubt that certified public accountants are the prime example of an "expert" upon whose authority underwriters and others (except the issuer) may rely in a registered securities offering. See, for example, §§7, 8(e), and Schedule A, Items (25)-(27) of 1933 Act, 15 U.S.C. §§77g, h(e), and (aa) Schedule A (25)-(27).

The standard by which the conduct of underwriters and others subject to potential liability under §11 of the 1933 Act is to be measured is enunciated in the statute, 15 U.S.C. §77k(c):

> "(c) In determining . . . what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property."

Here, the opinion below makes plain that Nuveen honestly believed that certified financials by WH's independent public accountants "correctly represented the condition of the issuer," and there is no suggestion in *Sanders II* that Nuveen had any reason to suspect otherwise. Until the decision in *Sanders II*, it had been generally accepted that financials certified by an independent public accountant could be relied upon as "made on the authority of an expert", and that those engaged in distribution of securities were protected against claims predicated upon misleading certified financials which honestly were believed to be accurate. *See, Escott* v. *BarChris Construction Corp.*, 283 F. Supp. 643, 697 (S.D.N.Y. 1968): "[T]he underwriters' counsel did not make a reasonable investigation of the truth of those portions of the prospectus which were not made on the authority of Peat, Marwick as an expert"; and, "Hence, they have not established their due diligence defense, except as to the 1960 audited figures." (Footnote omitted.)

As a practical matter, *Sanders II* eliminates reliance on WH's public accountants as experts. It says that Nuveen should have asked the accountants to "see any [of their] working papers used in the preparation of its semiannual statements," 524 F.2d at 1068, because Nuveen—character-

ized as an "underwriter"—"is under a duty to make at least some investigation directed at the question whether the *ever present* possibility of fraud is in fact a reality," * *Id.* at 1071. But it would here appear that the only potentially productive inquiry Nuveen could have made that would have revealed fraud in which WH's public accountants participated would have been to audit the auditors,** a hindsight standard of prudent conduct effectively requiring that all expert opinions not be relied upon regardless of the ostensible integrity, independence and competence of the expert.

The anomaly in imposing a higher duty upon "underwriters" through the medium of §10(b) of the 1934 Act than that specifically imposed upon underwriters under §11 of the 1933 Act is apparent. It is urged that this Court should speak to the question of whether expert opinions, particularly those of accountants, may be relied upon—in the absence of any ground to believe they are suspect—by participants in the distribution of securities.

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* Emphasis supplied since, if this possibility is "ever present", what Nuveen failed to do here presumably must be done by underwriters in all cases hereafter.

** That, of course, is what uncovered the fraud and caused both WH and its accountants to be criminally convicted. *Sanders II*, 524 F.2d at 1068 & n. 4.

III

This Court should state definitively the standard by which liability under Rule 10b-5 is to be determined.

At least three different and conflicting standards have been advanced by the circuit courts of appeals in respect of the standard of diligence required of defendants in searching for and disclosing material information to purchasers or sellers of securities. These differing tests can produce irreconcilable conclusions on issues of liability in cases under §10(b) of the 1934 Act and Rule 10b-5 thereunder; and the case at bar well illustrates that a defendant's liability may turn upon the fortuity of where he is sued.

Something akin to, albeit less stringent than, the proof of "scienter" required to establish common law fraud seems to be an essential element of a plaintiff's 10b-5 claim in the Second, Fifth and Tenth Circuits; *i.e.*, the defendant's material misstatement or omission must have been knowing or reckless. *See, e.g., Lanza* v. *Drexel & Co.*, 479 F.2d 1277, 1306 (2d Cir. 1973); *Vohs* v. *Dickson*, 495 F.2d 607, 622 (5th Cir. 1974); *Clegg* v. *Conk*, 507 F.2d 1351, 1361 (10th Cir. 1974), *cert. denied*, 422 U.S. 1007 (1975).

A negligence standard seemingly has been enunciated by the Eighth Circuit. *Vanderboom* v. *Sexton*, 422 F.2d 1233 (8th Cir.), *cert. denied*, 400 U.S. 852 (1970), and the Seventh Circuit apparently applied the negligence measure to defendant's conduct in *Hochfelder* v. *Ernst & Ernst*, 503 F.2d 1100, 1104 (7th Cir. 1974), *cert. granted*, 421 U.S. 909 (1975) (No. 74-1042).

Finally, there is the "flexible duty" standard fashioned by the Ninth Circuit in *White* v. *Abrams*, 495 F.2d 724 (9th

Cir. 1974). *Also see, Marx* v. *Computer Sciences Corp.*, 507 F.2d 485 (9th Cir. 1974). This measure of 10b-5 liability would rely upon a host of evaluative criteria, essentially geared to a case-by-case analysis of the circumstances. In the case at bar, the court below purported to apply the "flexible duty" standard:

> "... the broad question whether there is a generally applicable standard of culpability in Rule 10b-5 cases lying somewhere between the extremes of common law fraud on the one hand and mere negligence on the other. We assume the standard may be phrased differently in different circumstances." *Sanders II*, 524 F.2d at 1069 (footnotes omitted).

Under such a standard, however, as applied to "underwriters", surely consideration must be given to the congressional policy reflected in §11 of the 1933 Act which exculpates from liability underwriters who rely upon the opinions of independent experts (*see* Point II, *supra*).

Absent such consideration, what emerges from the opinion below is an unarticulated absolute liability standard. By imposing an affirmative obligation on Petitioners to ferret out "the ever present possibility of fraud", the "favorable recommendation of the issued security" found "implicitly" in Nuveen's relationship to respondent (524 F.2d at 1070), to whom no representation was claimed to have been made, comes perilously close to holding Petitioners to a guarantee by Nuveen that WH's notes would be paid when due.

Whatever the standard of conduct by which an underwriter's or dealer's liability is to be determined, it patently

should not depend upon the fortuity of where he may be sued. The members of SIA—who engage in distribution of securities in nationwide offerings—find themselves in the unenviable position of having their 10b-5 liabilities measured differently in different circuits. In the circumstances, a clear statement by this Court as to the standard for determining 10b-5 liability is essential to the orderly transaction of business in the securities markets of the Nation.

CONCLUSION

For the reasons stated, the petition for a writ of certiorari to the Court of Appeals for the Seventh Circuit should be granted.

February 2, 1976

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